

Notice of Proposed Regulatory Action

**The State Board of Equalization Proposes to Adopt Amendments to
California Code of Regulations, Title 18, Section 1502,
*Computers, Programs, and Data Processing***

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, which prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. The proposed amendments to Regulation 1502, subdivision (f)(1)(C) clarify that a maintenance contract sold in connection with the sale or lease of a prewritten program, including an optional maintenance contract subject to tax at 50 percent of the lump-sum charge, may provide that the purchaser is entitled to receive a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. The proposed amendments to Regulation 1502, subdivision (f)(1)(D) clarify that subdivision (f)(1)(C)'s provisions regarding the taxation of optional maintenance contracts apply to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D).

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on December 17-19, 2013. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:30 a.m. or as soon thereafter as the matter may be heard on December 17, 18, or 19, 2013. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1502.

AUTHORITY

RTC section 7051

REFERENCE

RTC sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

Subdivision (f)(1) of Regulation 1502 prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting

periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

Effects, Objectives, and Benefits of the Proposed Amendments to Regulation 1502, subdivision (f)(1)(C) and (D)

Need for Clarification

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer's charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as "optional" so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which "improvements" and "error corrections" are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to "improvements" and "error corrections." Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that

expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board's January 15, 2013, Business Taxes Committee meeting. Staff recommended that the Board authorize staff to conduct one focused interested parties meeting regarding clarifying amendments to Regulation 1502 to address the issue. And, the Board unanimously voted to approve staff's recommendation.

Interested Parties Process

Board staff subsequently reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of prewritten programs to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) that would have the effect and accomplish the objective of clarifying that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) that would have the effect and accomplish the objective of clarifying that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

Next, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013. During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Therefore, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data.

August 13, 2013, Business Taxes Committee Meeting

Board staff subsequently prepared Formal Issue Paper 13-007, which recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. The Board considered staff's recommendation during the August 13, 2013, Business Taxes Committee meeting, and, at the conclusion of the meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 would have the effects and accomplish the objectives of clarifying that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle

customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1502, subdivision (f)(1) are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1502, subdivision (f)(1) contains the only provisions in the state's regulations that specifically prescribe the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs, and the proposed amendments are consistent with the existing provisions of Regulation 1502, subdivision (f)(1). In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1502, subdivision (f)(1) or the proposed amendments to Regulation 1502, subdivision (f)(1).

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1502 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has prepared the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will not affect the benefits of Regulation 1502 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of the proposed amendments to Regulation 1502 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at

Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:30 a.m. on December 17, 2013, or as soon thereafter as the Board begins the public hearing regarding the adoption of the proposed amendments to Regulation 1502 during the December 17-19, 2013, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regulation 1502. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an underscored and strikeout version of the text of Regulation 1502 illustrating the express terms of the proposed amendments. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1502, which includes the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt the proposed amendments to Regulation 1502 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such

changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts the proposed amendments to Regulation 1502, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.